

Spain at the Crossroads

Iberian Days

London, september 15th, 2011

Key themes

- 1 Economic policies and outlook:** prospects conditioned by delays on how to tackle fiscal problems in Europe and the US, which are also affecting the banking system.
- 2 Europe:** July's summit, initially a positive surprise, has shown itself to be clearly insufficient to solve Greece's solvency problems. Economies with high risk premiums have already seen growth undermined as a result
- 3 Spain:** Second quarter with weaker growth of 0.2% (0.7% year-on-year), diminishing the prospect of sustained job creation. The Spanish economy is still stuck in a pattern of low activity and employment, with downward pressure on growth.
- 4** The higher contribution to growth by net trade is still one of the silver linings of the downturn
- 5** No other alternative than the intensification of structural reforms to reduce uncertainties of international financial markets and increase (internal and external) confidence

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International environment: politics takes centre stage in the economic debate

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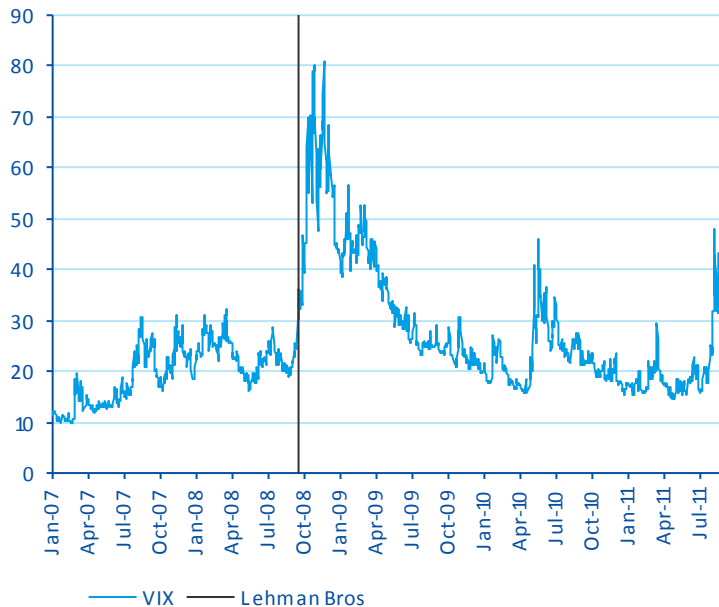
Section 1

Climate of very high uncertainty

- The global economy has undergone a period of strong financial pressures since July.
- The current climate is marked by high volatility, risk aversion and the flight of capital to safe-haven assets, and this is likely to continue in the short term

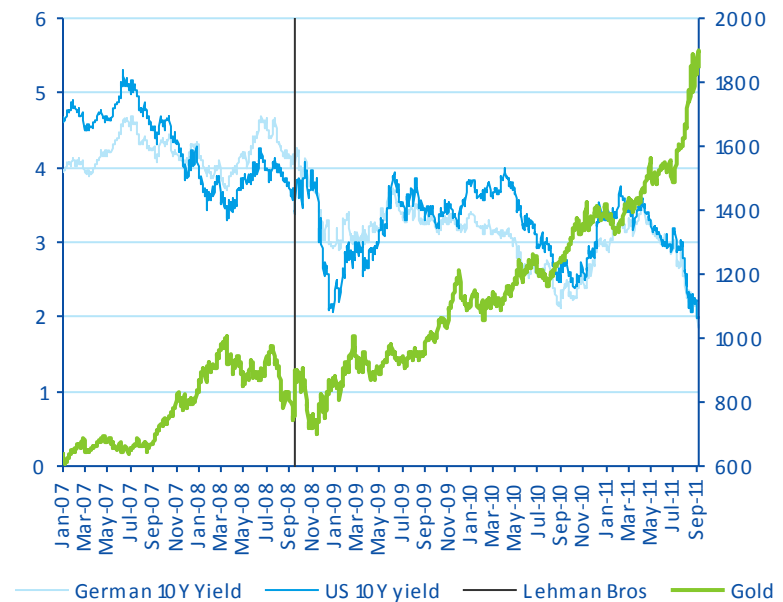
Global risk aversion: VIX Index

Source: Bloomberg and BBVA Research



Refuge assets: gold and German and US treasury bonds

Source: Bloomberg and BBVA Research



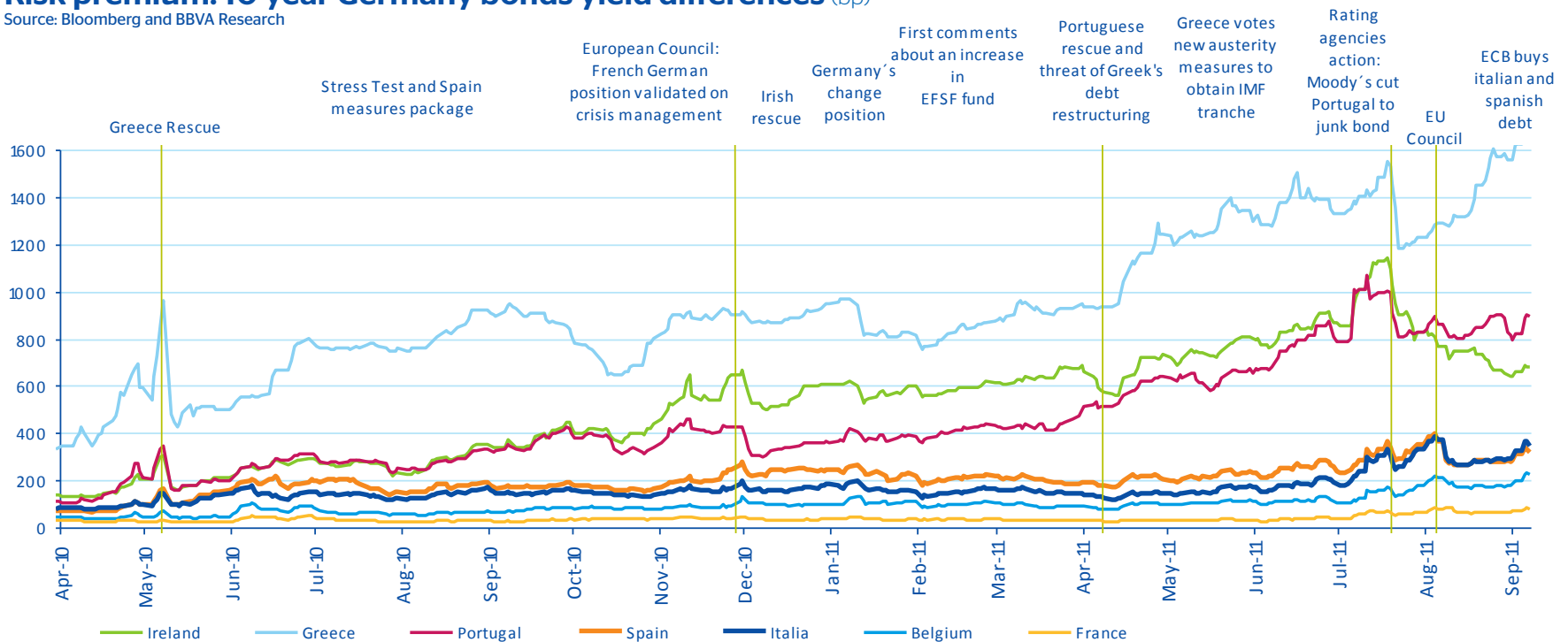
Section 1

Intensification of the sovereign crisis

- In Europe, there has been a **resurgence of sovereign debt crises**. The results of July's Summit failed to meet the mark: the rescue mechanism has been made more flexible, but there are **doubts surrounding its implementation** and it is perceived as insufficient.

Risk premium: 10 year Germany bonds yield differences (bp)

Source: Bloomberg and BBVA Research



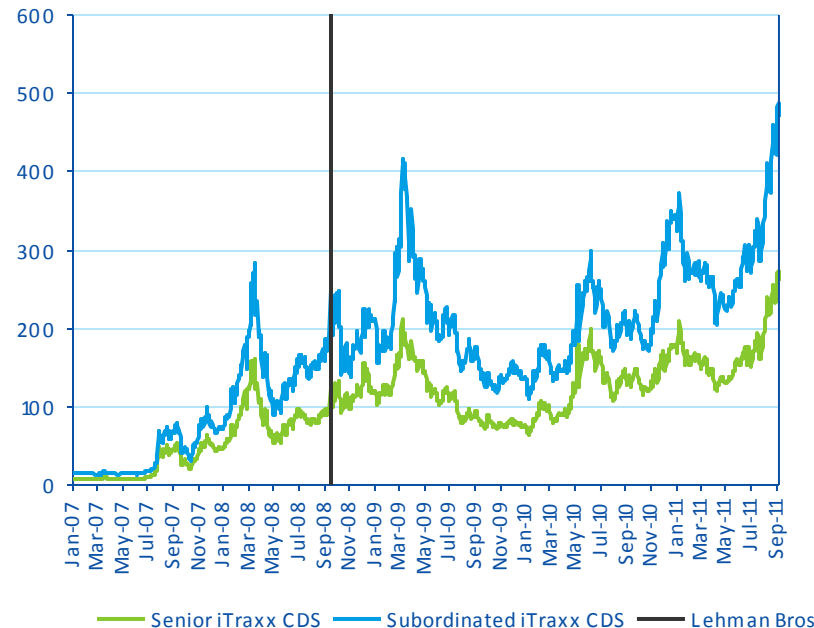
Section 1

Sovereign crisis affecting banking risk

- Uncertainty about solving the debt crisis, together with the banks' exposure to non-core debt, contributes to a worsening of the perception of the banking system. Insurance costs have rocketed and risk affects financing conditions in the interbank market

Banks insurance cost: CDS

Source: Bloomberg and BBVA Research



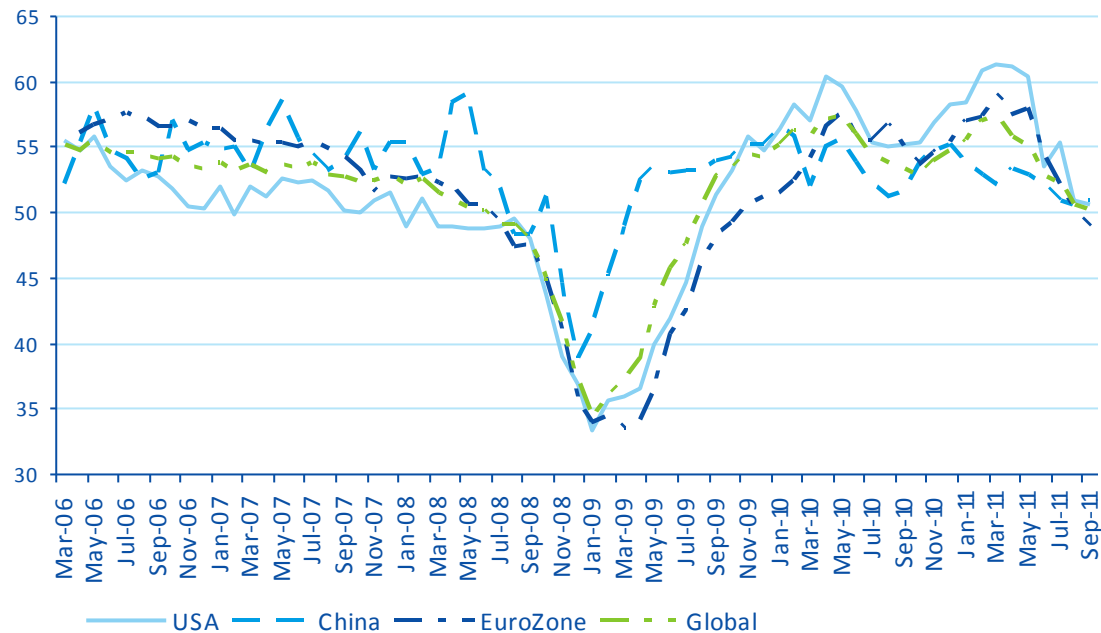
Section 1

Weak growth prospects

- In the United States, the risk of recession is increasing after the unpleasant surprise of new economic data. In this context, the lack of political consensus in the debate about the debt ceiling is evident which has culminated in the rating downgrade
- Cyclical risk together with financial risk translates as a fall in confidence indicators across the globe, especially in developed economies

Activity forecasts indexes: EuroZone, United States, China and Global

Source: Bloomberg and BBVA Research



Section 1

Baseline scenario

- The **European sovereign crisis** is, without doubt, the key factor which will affect the economic scenario looking forward, but it is not the only factor

Europe: work to be done to halt the debt crisis

- Approval and **implementation of the agreements** reached at the Summit on 21 July
- Take additional steps at European level towards **improved coordination** of fiscal and economic policy in the Euro zone
- **Implementation of ongoing programmes in peripheral countries** and agenda for more reforms



BASELINE SCENARIO

- **Slow but favourable (partial) resolution** of these elements will allow the gradual relaxation of risk premiums and the financing conditions of the banks
- In any event, economies will continue to show **weak growth** in the coming year
- **Lower probability of the baseline scenario** has been reduced given the weakness of the economies to face shocks and the lower margin of policies

Section 1

Risk scenario

- ➔ The **likelihood of the risk scenario has increased** considerably in the past month given the intensification and extension of financial tensions
- ➔ The **elements that could trigger this scenario are numerous** given the delicate financial situation in Europe (**from a default by Greece to the failure to approve or implement the EFSF**) and the cyclical weakness of the US economy
- ➔ **In this scenario, developed economies would enter recession in 2012, with a more virulent impact in Europe**

Section 1

Looking forward

The European sovereign crisis is, without doubt, the key factor which will affect the economic scenario looking forward, but it is not the only factor. The risk of a double dip in USA has increased

Economic Growth GDP (CD July 2011 vs September 2011)

Source: BBVA Research

	2010	2011	Sept. revision	2012	Sept. revision
USA	2.9	2.5	↓ ↓	2.7	↓
EMU	1.7	2.0	↓	1.3	↓
EAGLEs	8.3	7.0	=	6.9	=
World	5.0	4.3	↓	4.5	↓

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Spain: growth still weak

Determining factors of the macroeconomic scenario

Source: BBVA Research

		FACTOR	
New factors		New NA data (2Q11)	Growth is weakening compared to 1Q11
		Structural reforms	Limited reform to collective bargaining, which does not solve the problems. Labour market problems still not solved.
		Fiscal consolidation	The adjustment to public consumption in 2Q11 is insufficient in the light of the situation of the regional governments.
		Monetary policy	The ECB would once again delay increases in rates to 2012
		Financial stress	Increase in risk premium (+50bp on average in 2011 and 2012)
		Foreign demand	Slowdown in global growth

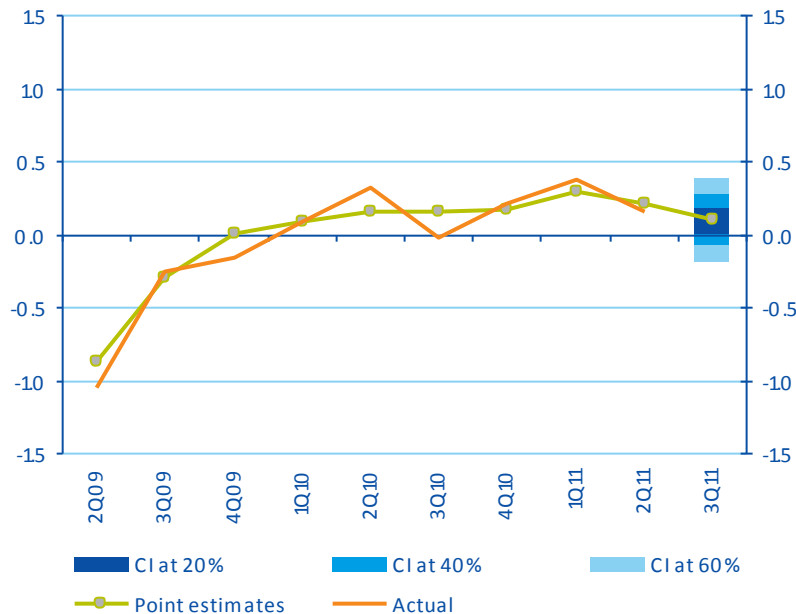
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Spain: growth still weak

After a better than expected 1Q11, the growth of 2Q11 and the 3Q11 data point to a slowdown

Spain: observed GDP growth and forecasts based on the MICA-BBVA model (% q/q)

Source: BBVA Research based on INE
Actual forecast: Sept 8th 2011



The main characteristics of the short-term outlook for the Spanish economy are still:

- Lack of job creation
- Weak domestic demand, fiscal adjustments
- Negative contribution to growth by domestic demand
- Foreign demand is the main driver

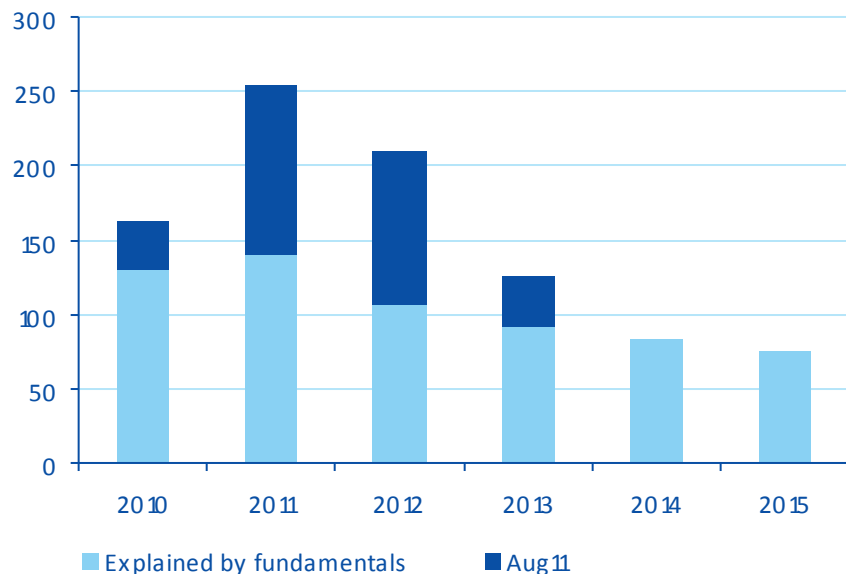
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Spain: financial stress

The intensification of stress in sovereign debt markets (higher risk premiums: +50bp in 2011 and 2012, but of a temporary nature in our baseline scenario) will have a negative effect on GDP growth

Spain: sovereign risk premium (vs. German 10Y bond)

Source: BBVA Research



The cumulative effect of this factor alone would be a decrease in GDP growth of 5-8 tenths in 2012

Consumer and business confidence virtually unchanged

Section 2

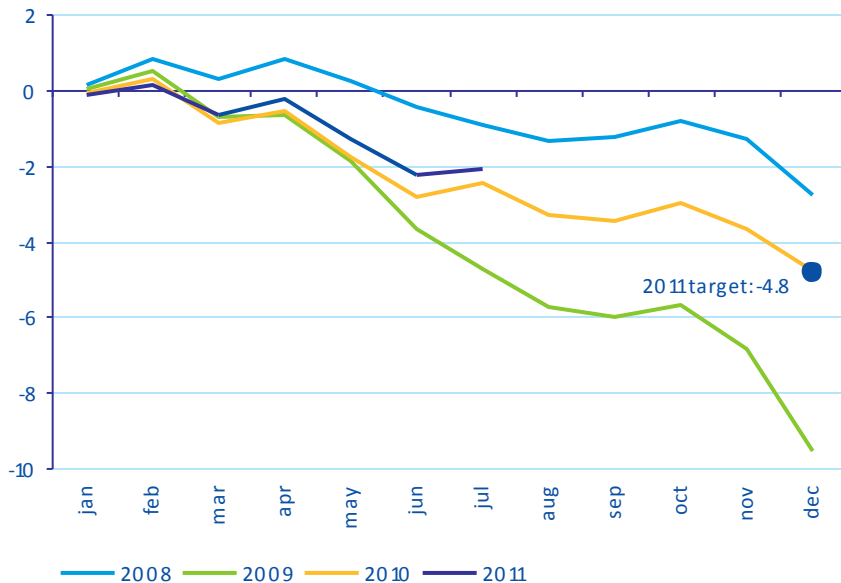
Spain: budgetary performance

- The **Central Government** will comply, with revenue potentially exceeding forecasts by a few tenths
- Doubts in the **Social Security** and especially in **regional government** budgets. Six regional governments have already announced shortfalls of 1 pp of GDP for the end of the year.

Central Government budget balance

(Accumulated over the year as percentage of GDP)

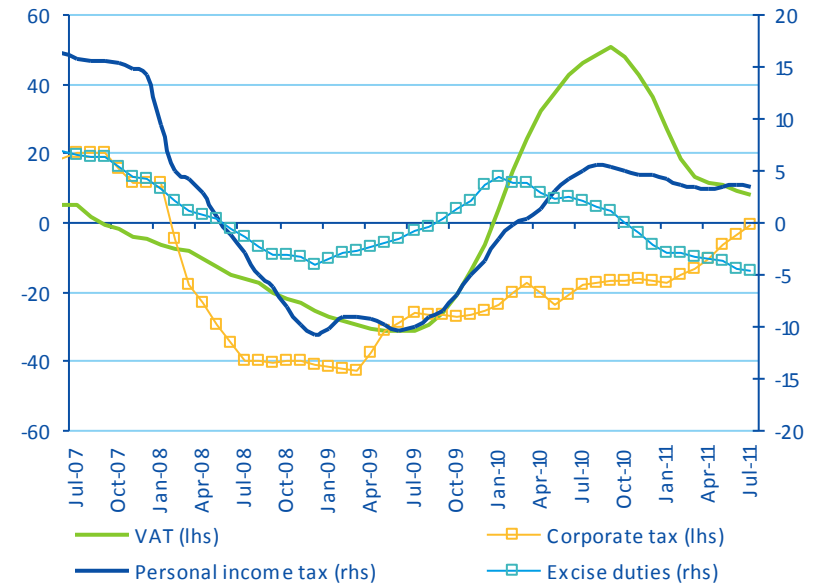
Source: BBVA Research based on MEH



Tax revenue

(12m centred moving average annual % homogeneous variation)

Source: BBVA Research based on AEAT



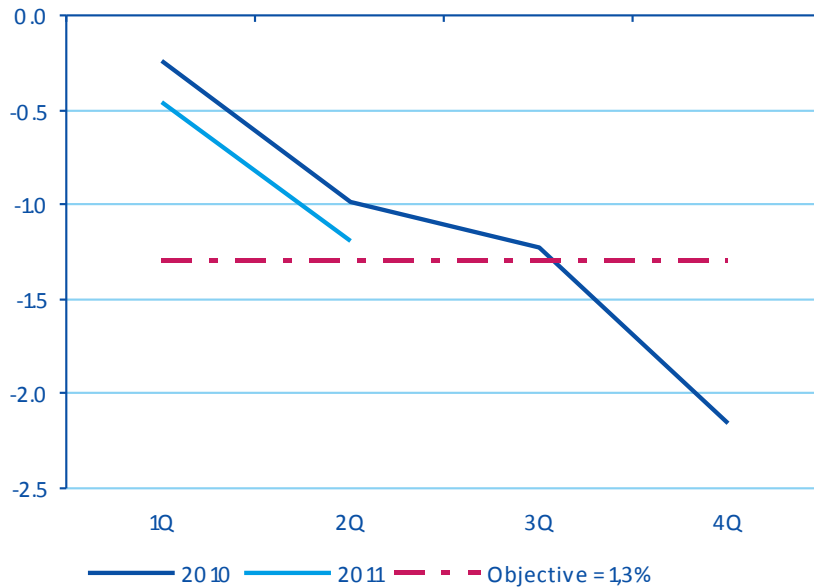
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Spain: budgetary performance

- The current situation of the regional governments could lead to them falling short of their target by one point of GDP

Autonomous Communities budget deficit: (% GDP)

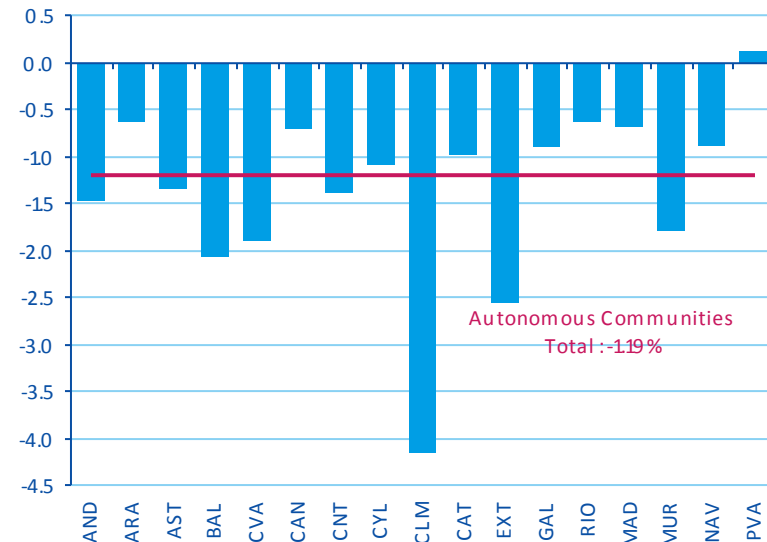
Source: BBVA Research based on EAT



Autonomous Communities budget balance.

Budget execution at 2Q11 (% of regional GDP)

Source: BBVA Research based on MEH and INE



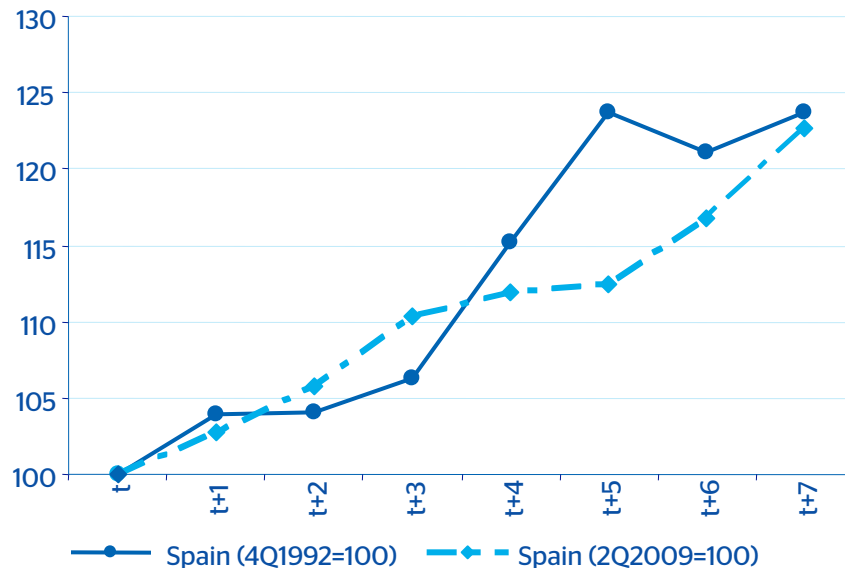
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Spain: foreign trade

Uncertainty about the continuity of a positive growth scenario in the EMU makes it difficult to offset the slowdown in global economic growth

Quarterly evolution of real goods and services exports in two end of crisis episodes

Source: BBVA Research



Overall, goods and services exports:

- Above pre-crisis levels
- Performance in line with the recovery after the crisis in the 90s despite the absence of currency devaluation as in the past
- Diversified growth (sectors and countries) →
BBVA Research Web

Note: t corresponds to the cyclic minimum local in the quarter

Section 2

Spain: growth still weak in 2012

Economic forecasts

Source: INE, Bank of Spain, Eurostat and BBVA Research

(yoy %)	20 10		20 11		20 12	
	Spain	EMU	Spain	EMU	Spain	EMU
Household consumption	13	0.8	0.3	12	0.6	13
Public Administration's consumption	-0.7	0.3	-0.2	0.6	-1.3	0.1
GFCF	-7.5	-10	-4.9	3.3	-0.4	2.7
Capital goods and other products	-2.1	3.1	0.6	6.1	3.0	4.0
Construction	-11.1	-3.9	-9.1	0.0	-2.9	0.8
Housing	-16.5	-2.9	-7.5	0.6	0.9	10
Domestic demand (*)	-1.1	0.9	-10	15	0.0	12
Exports	10.3	11.1	11.0	6.4	6.0	3.2
Imports	5.5	9.3	3.7	5.6	10	3.2
Net trade balance (*)	10	0.8	18	0.5	13	0.1
GDP at mp (yoy %)	-0.1	1.7	0.9	2.0	1.3	1.3
Pro-memoria						
GDP w/o housing investment	0.9	1.9	1.3	2.1	1.3	1.3
GDP w/o construction	1.7	2.3	2.3	2.2	1.9	1.4
Employment (LFS)	-2.3	-0.4	-0.8	0.5	0.5	0.7
Unemployment rate (% active pop.)	20.1	10.2	20.8	9.8	20.7	9.5
Current account balance (% of GDP)	-4.5	-0.4	-4.0	-0.2	-1.6	-0.1
Public sector balance (% of GDP)	-9.2	-6.0	-6.0	-4.4	-4.4	-3.6
Annual average CPI	1.8	1.6	3.0	2.7	1.4	1.8

(*) contribution to growth

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The challenges of the Spanish economy

- Spain does not have a solvency problem, but a liquidity problem
- Advances have been made, but due to the situation of the economy and international markets, these are not sufficient

Problems in the periphery

- 1 Greece**
 - High public deficit and debt
 - Doubts surrounding public accounts
 - High foreign deficit
- 2 Ireland**
 - Oversized banking industry
 - Private indebtedness
 - Real estate bubble
- 3 Portugal**
 - Scant growth and productivity
 - Rigid public deficit
 - Stubborn foreign deficit

Risks linked to Spain

Fiscal consolidation

Bank restructuring

Structural reforms to foster growth and employment

Section 3

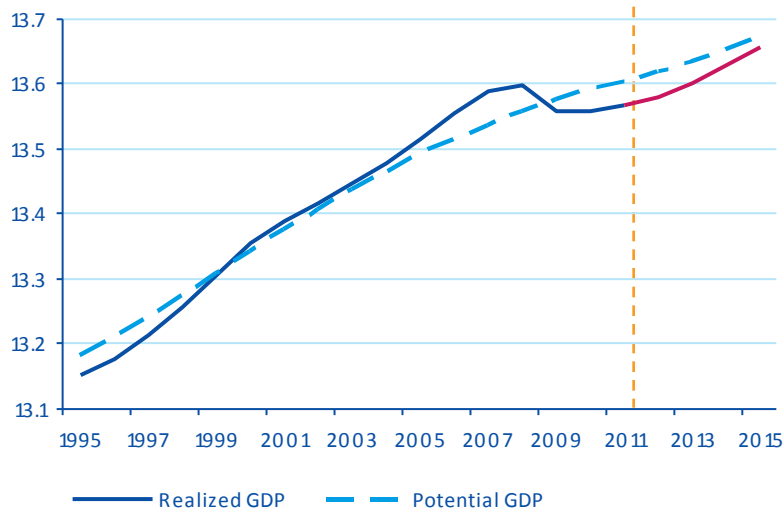
Fiscal consolidation

Constitutional reform

- The budget balance can be broken down into a structural component and a cyclical one
- The cyclical component reflects the effects of the automatic stabilizers on the deficit
- This cyclical component of the budget balance is associated with the cyclical component of the GDP, also known as the output gap: percentage difference between GDP and its long-term trend growth

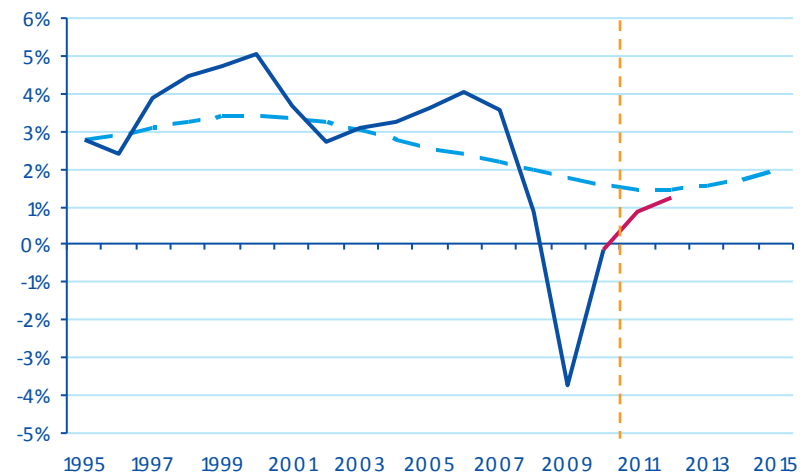
Real GDP and trend component (in logs)

Source: BBVA Research



Observed and potential growth (a/a)

Source: BBVA Research



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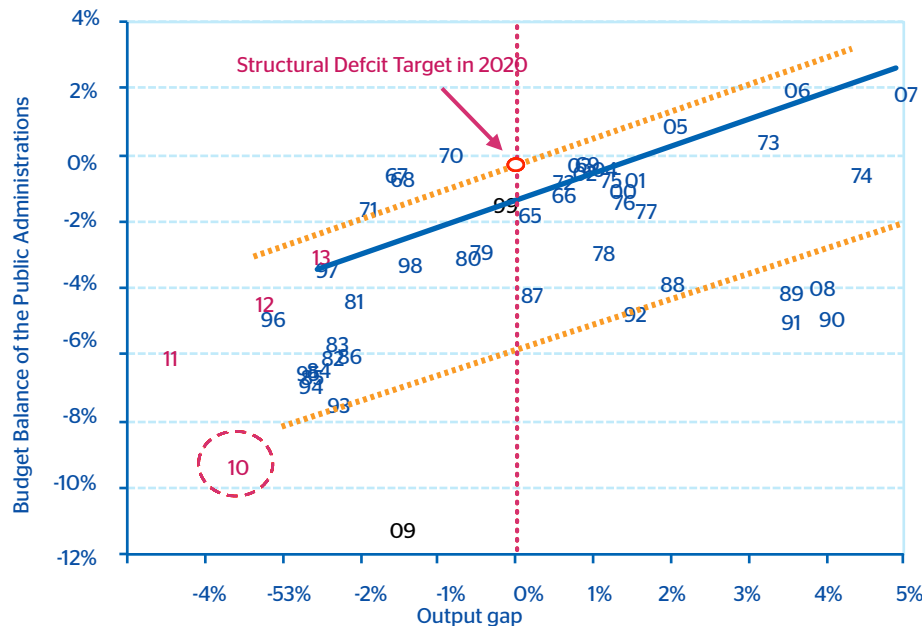
Fiscal consolidation

Constitutional reform

- Each point of the output gap is equivalent to 0.8 points in the cyclical deficit.
- The intersection of the line that reflects the sensitivity of the budget balance to the economic cycle with the vertical line for the zero output gap determines the structural budget balance.
- Between 1997 and 2007, there were hardly any significant variations in the structural budget balance.

Budget balance and cyclic position

Source: BBVA Research based on MEH and INE



Evidence

- In 2007, the structural deficit was above 1.5% of GDP
- With the crisis, the structural deficit has surpassed 8%
- If the target of the Stability Plan is met, Spain would return to a similar situation to that of 2007

Section 3

Fiscal consolidation

Fiscal structure:

- The greater margin of maneuver is in the taxation on consumption.
- The **progressivity in employment income** in Spain is similar to that of EMU.
- The **effective rate on companies' earnings** is slightly higher than France, Germany or the EU15

Political economy reasons and economic efficiency warrant **first reducing spending as much as possible** and , only after that, improving public services and investments by tax increases

Effective tax rates

	Spain	EU
Labour	33.1	33.8
Marginal IRPF (personal tax)	45-49	37.1
Capital	31.7	25.3
Corporations	22	20
Consumption	14.1	21.4

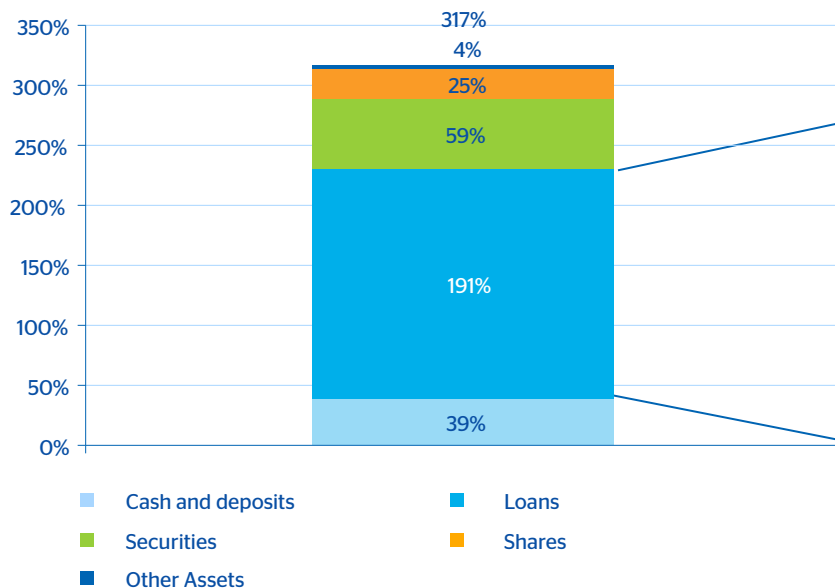
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Solvency: mainly in the real estate sector

- Problems are mostly in exposure **to the real estate sector**

Spanish Financial System: Structure of Balance sheet (%GDP, Dec-10)

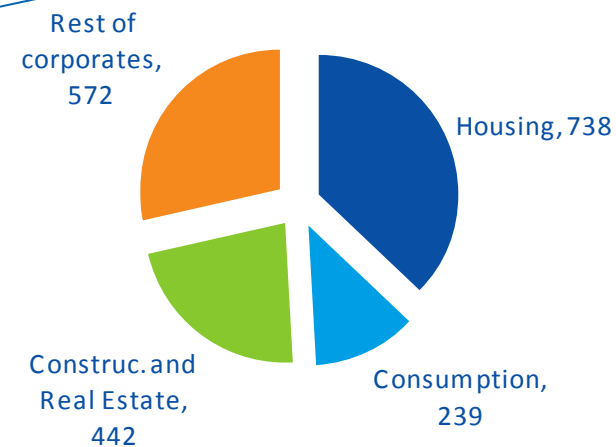
Source: BBVA Research based on Bank of Spain



Spanish Financial System: Loans (bn EUR, Dec-10)

(bn EUR, Dec-10)

Source: BBVA Research based on Bank of Spain



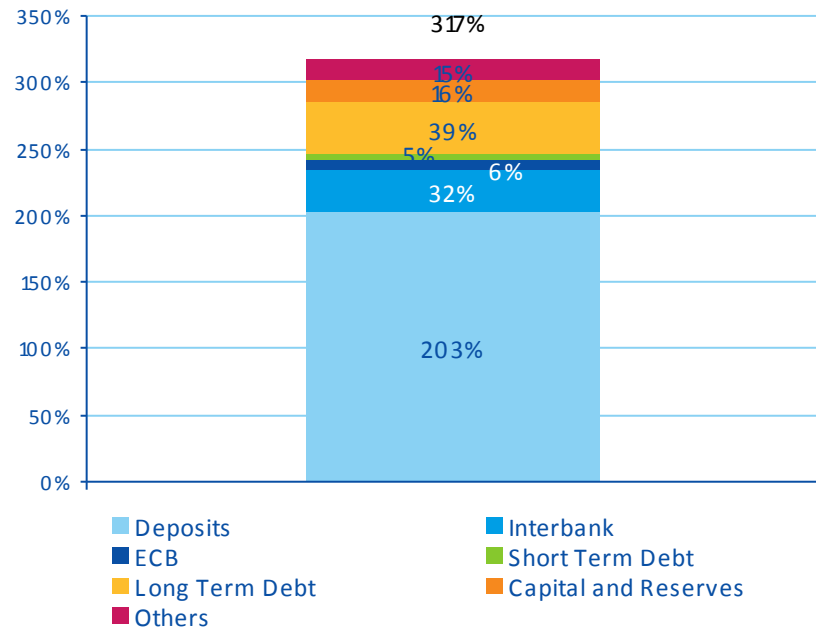
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Liquidity: needs of the Spanish economy

- The system has a **solid base of deposits**, but short-term financing depends very much on **international financial markets**

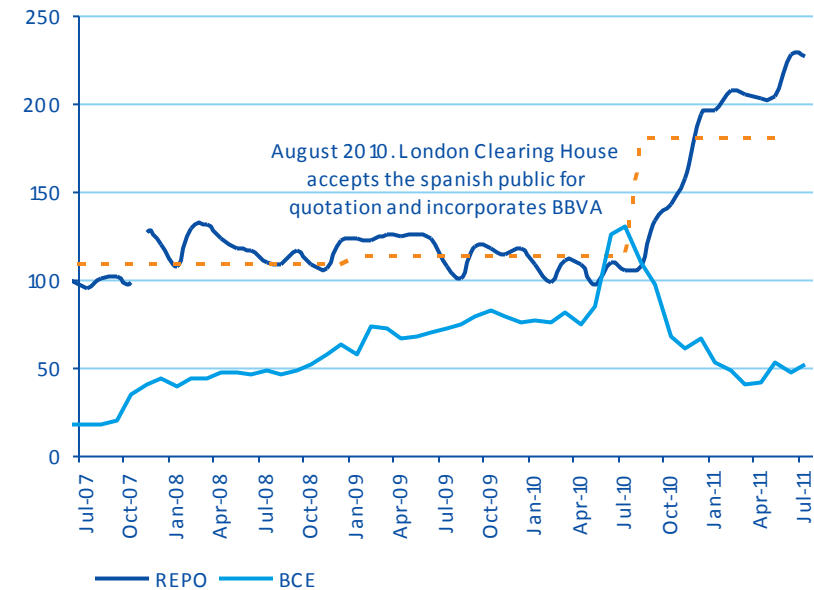
Spanish Financial Systems: Liabilities (%GDP, dec-10)

Source: BBVA Research based on Bank of Spain



Total temporary assignment of assets* and ECB appellation (billion EUR)

Source: BBVA based on Bank of Spain



*The statistics of temporary assets assignment to financial institutions are incomplete, only the historical series of public administrations temporary assignments from november 2007 is available

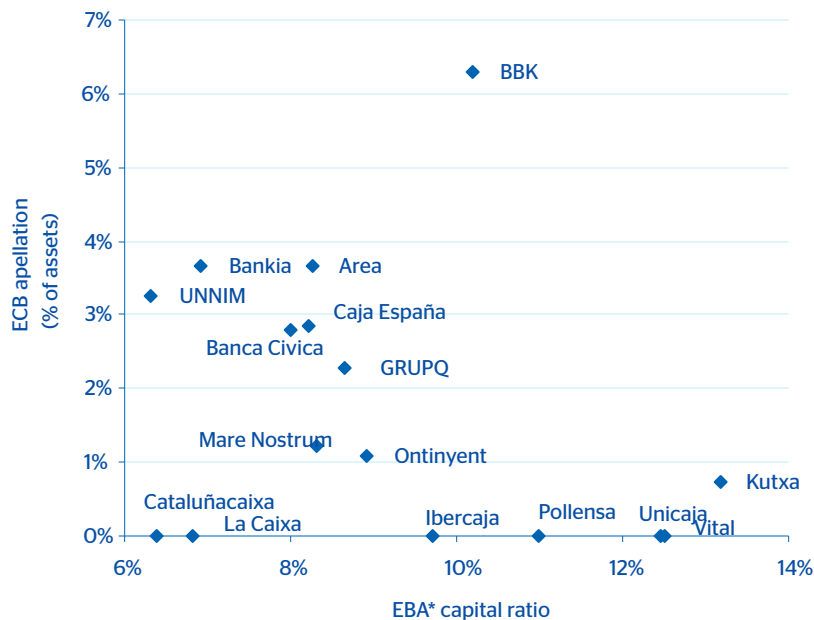
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Bank restructuring

- **The problems are concentrated in some entities (1/3 of the system)**, as those with liquidity problems are often those with the poorest solvency

Savings banks: solvency and ECB dependency

Source: BBVA Research based on EBA and CECA

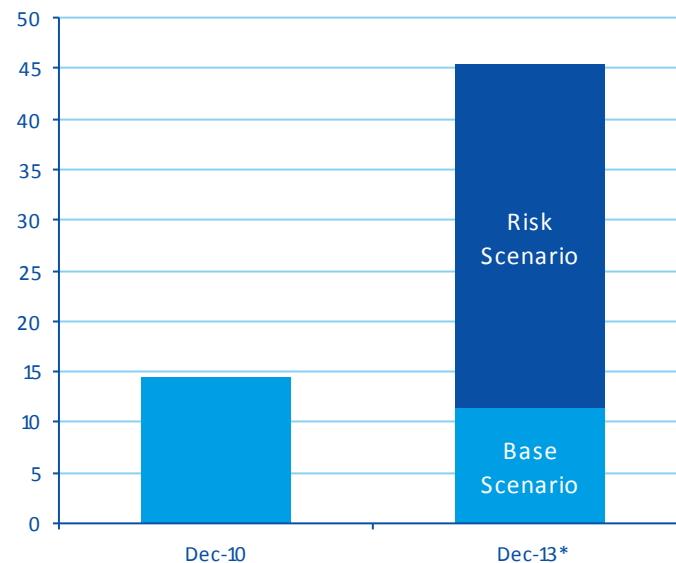


* Core Tier 1st of december 2010

Actual needs

(Accumulated bn EUR, it does not include de 15,3tM already injected)

Source: BBVA Research



*8% Minimum Capital Tier 1

Section 3

Spain needs to step up reforms

The need for **institutional and structural reform to achieve economic convergence**

- **Convergence hypothesis before the crisis:** monetary and economic integration would be sufficient for economic convergence → growth → capital flows and reduced risk premiums
- **With this crisis, the markets have concluded that this hypothesis was not correct:** there are significant differences between European countries in their structural capacities, in fiscal policies and in institutions

Need for structural reform in developed countries

Source: IMF and BBVA Research

	Liberal Market Economies			Coordinated Market Economies									Mixed market Economies				Avge.
	UK	USA	IRL	GER	FRA	NLD	BEL	AUT	FIN	DEN	SWE	JAP	SPA	ITA	POR	GRE	
Medium Term																	
Labour market	1	1	1	2	3	2	2	2	1	1	2	1	3	3	3	3	1.9
Corporate regulations	1	1	1	2	2	1	3	2	2	1	1	2	3	2	2	3	1.8
Network regulations	1	1	3	1	2	1	1	1	2	1	1	2	1	2	2	3	1.6
Retail	1	1	1	1	2	1	3	3	2	2	1	1	2	2	2	3	1.8
Professional services	1	1	1	3	2	1	2	2	1	1	1	1	2	3	2	3	1.7
Long term																	
Institutions and contracts	1	2	2	1	2	1	2	1	1	1	2	2	2	3	3	3	1.8
Human capital	2	2	1	2	2	1	1	2	1	1	1	1	3	3	3	3	1.8
Infrastructure	1	1	3	1	1	1	2	2	2	1	1	1	1	3	2	3	1.6
Innovation	1	1	2	1	1	1	1	2	2	1	1	1	3	2	3	3	1.6
Average	1.1	1.3	1.7	1.6	1.9	1.1	1.9	1.9	1.6	1.1	1.2	1.3	2.2	2.6	2.4	3.0	1.7

Section 3

More ambitious reforms needed

Reforms carried out are insufficient

- Duality and temporary nature of employment continues
- Timid advances in agreements at company level
- Arbitration does not eliminate "ultra-activity"
- Proposal still restrictive in terms of internal flexibility
- The possibility of removing wage-related clauses from collective agreements is still complicated
- Temporary employment will hinder the training of young unemployed people

Competitiveness

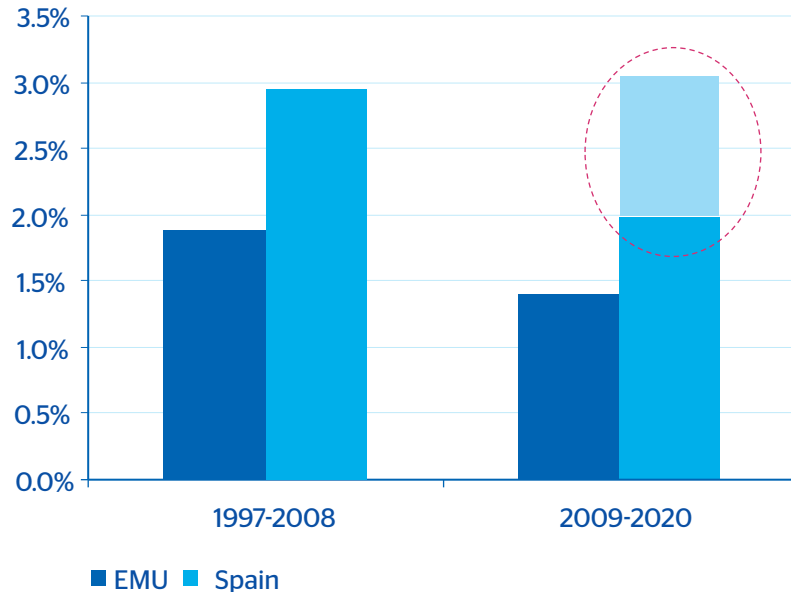
- More efficient taxation system
- Fiscal Rule: good implementation of the constitutional reform. Improvement in public financing in the medium term
- Internal market
- Lower administrative costs
- Continuous review of the sustainability of the pensions system
- Reduction in energy dependence
- Pact for education and health

Section 3

Spain needs to step up ambitious reforms

Spain vs. EMU: potential GDP (% a/a)

Source: BBVA Research



- Baseline scenario: 1 pp in the unemployment rate per year during the next decade (13y to 8%)
- Structural reforms: higher potential growth and lower structural unemployment (7y to 8%)

GDP growth and its components (contribution in pp average per period)

Fuente: BBVA Research

	Potential Growth		Capital		TFP		Employment	
	1997-2008	2009-2020	1997-2008	2009-2020	1997-2008	2009-2020	1997-2008	2009-2020
Spain	2,9%	2,0%	1,2%	0,6%	0,5%	0,9%	1,3%	0,4%

Spain at the Crossroads

Iberian Days

London, september 15th, 2011

Appendix